SBCA REQUESTS IMMEDIATE ENACTMENT OF HR 4068 "THE SMALL BUSINESS PENALTY RELIEF ACT OF 2009"

The Small Business Council of America endorses HR 4068, the Small Business Penalty Relief Act of 2009 and requests immediate enactment in order to save many small businesses prior to March 1, 2010, which is when the extended IRS collection moratorium ends. If legislation is not passed and the IRS' moratorium expires on March 1, 2010, many small businesses face devastating collection actions, and their owners and businesses probable bankruptcy. Unlike most tax issues facing Congress that are relatively technical and dry, it is no exaggeration to say that 6707A is a financial life or death issue for affected small businesses and their owners. Absent Congressional action enacting HR 4068, these businesses will be ruined financially, as will their owners. Of course, being hit with penalties that in some cases exceed total lifetime earnings causes personal, family and health issues as well.

BRIEF TECHNICAL BACKGROUND

Section 6707A of the Internal Revenue Code ("section 6707A") was enacted in the American Jobs Creation Act of 2004 to shut down multi-million-dollar abusive tax shelter transactions by imposing a strict liability penalty on taxpayers unless they disclosed the transactions to the IRS. Section 6707A imposes a penalty of $100,000 per individual and $200,000 per entity for each failure to make special annual disclosure with their tax returns of Form 8886 (Reportable Transaction Disclosure Statement) with respect to a transaction that the IRS characterizes as a "listed transaction" or "substantially similar" to a listed transaction.

Since enactment of 6707A, IRS has on an ad hoc basis decided that over 35 transactions are "listed transactions". Many of these transactions deal with retirement and/or welfare plans primarily sold to small businesses by insurance brokers. In the vast majority of those cases, the small business owners had no idea that they had entered into a transaction that IRS would ultimately deem to be a "listed transaction".

It is important to understand that, other than tax professionals, most individuals would have no idea after reading an IRS publication setting forth a new "listed transaction" what the transaction is. In fact, even tax professionals disagree as to whether certain transactions would be covered as a listed transaction. Very often, these are not the type of tax shelters that most people think of as abusive tax shelters. Most small business owners who are facing this nightmare penalty, had never heard of a "listed transaction"

let alone 6707A penalties and they were not advised by their advisors or the individuals who promoted the plan to them that they had to disclose the transaction to the IRS.

While the SBCA supports the spirit of disclosure of transactions having a high potential for abuse in order to better administer our uniquely voluntary tax system, under the law of unintended consequences, the IRS determined that certain transactions, including certain retirement and welfare benefit plans that had been adopted by small businesses to provide retirement security for their employees were "listed transactions" subject to taxpayer disclosure to avoid the penalty. The tax benefits received from many of those retirement and welfare benefit plans were relatively small -- in the thousands of dollars, not the millions. Accordingly, the imposition of section 6707A penalties on small businesses and their owners were disproportionate to the tax benefit received when compared to the tax benefit realized by major corporations.

If a large C corporation enters into an abusive tax shelter, sheltering large sums of income from taxes, and fails to disclose that it had entered into a listed transaction, it is hit with a $200,000 penalty for each open tax year. In contrast, a small business operating as a S corporation with 5 stockholders, which enters into what the owners did not consider an abusive tax shelter (and might turn out not to have saved *any* tax dollars), would be hit with the same $200,000 penalty for each open year and each stockholder would also be subject to a $100,000 penalty. Unlike the large C corporation where $600,000 (3 x $200,000) is less than a bee sting, for the small business, the 6707A penalties ($2,100,000 -- 3 x $200,000 + $500,000 x 3) are the equivalent of a nuclear bomb. In many cases, the small businesses are being hit with penalties that are more than the owners have made from the small business throughout their lifetimes. The 6707A penalty applies in addition to accuracy related penalties and even if the transaction is ultimately determined to be tax compliant.

TAXPAYER ADVOCATE FINDS 6707A UNFAIR, MAYBE UNCONSTITUTIONAL

The National Taxpayer Advocate 2008 Annual Report to Congress, at page 421, states:

> "Notwithstanding the underlying congressional intent in enacting Section 6707A, the statute as written can impose unconscionable hardship on taxpayers. Even the penalty for proven cases of civil fraud is capped at 75 percent of the tax underpayment. Yet this statute allows penalties of up to $300,000 per year to be imposed on taxpayers with no underpayment of tax and no knowledge that they entered into transactions that the IRS has 'listed'. *It is rare that a tax provision is found to violate the United States Constitution, but we believe that the imposition of such a large penalty on a taxpayer who entered into a transaction that produced little or even no tax savings and without regard to the taxpayer's knowledge or intent raises significant constitutional concerns, including possible violation of the Eighth Amendment's prohibition against excessive government fines and due process protections.*
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> "In practice, the requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no

intention of entering into a tax shelter - an outcome that has dismayed even hardened IRS enforcement personnel." (emphasis added)

HR 4068 and S 2771 - The Small Business Penalty Relief Act of 2009 ("SBPRA")

The immediate enactment of SBPRA represents a major step to correct what Congressional leaders in the Senate and the House agree places an unintended and disproportionate burden on small business and their owners. In some cases small business owners did nothing more than invest in retirement and health and welfare plans to provide retirement income security for their employees. **In fact, most of the small business owners never thought they were entering into an "abusive tax shelter" and would certainly not have done so if they had been told that IRS thought that they were and would hit them with non-disclosure penalties in the hundreds of thousands of dollars if not millions.**

SBPRA helps protect small businesses and their owners by limiting the Code section 6707A penalty for failure to report participation in a listed transaction to a proportionate 75% of the decrease in tax shown on the return as a result of such transaction, subject to the maximum provided under current law and a new minimum of $10,000 for an entity and $5,000 in the case for a natural person.

ILLUSTRATION OF HOW SECTION 6707A CAN DESTROY A SMALL BUSINESS

One taxpayer (from Iowa, and noted below in the further examples) who approached Congress and the SBCA for assistance entered into a transaction to provide benefits to his employees. The taxpayer relied on the advice of qualified independent tax professionals who told the small business owner that the transaction was *not* a listed transaction, and was not "substantially similar" to one. The transaction netted a deduction of only about $50,000. The IRS determined that the transaction was a listed transaction, and is asserting penalties of over $1 million against the taxpayer and his company. The taxpayer cannot go to court to challenge the IRS' determination without first paying the $1 million+ penalty, which he does not have. The IRS is holding off on taking steps towards seizing his assets until March 1, 2010 (i.e., while the collection moratorium is in place); however, once it expires and absent the passage of SBPRA (or similar legislation), both the taxpayer and his company will likely be forced into bankruptcy. The enactment of SBPRA will reduce his penalty to approximately $120,000
The SBCA has attached additional examples of Americans and their small businesses that face financial ruin due to the assessment (or threatened assessment) of section 6707A penalties.

The SBCA is the only national nonprofit organization whose sole purpose is to represent the interests of privately and family-owned business in federal income and estate tax, health care, pension and other employee benefit matters. The primary goal of the SBCA is to support legislation that creates important economic incentives and to oppose burdensome laws and proposals that negatively affect America's small businesses and their owners.

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THE UNINTENDED IMPACT OF CODE SECTION 6707A

EXAMPLES IN "REAL LIFE" FROM TAXPAYERS RESIDING THROUGHOUT THE COUNTRY

Taxpayers and His Children face $900,000 Penalty: A Utah businessman established a small business which was owned by his family. His family owners were each of his six minor children and his wife and him. The business owner established a pension plan and the IRS determined that is was a listed transaction and assessed $900,000 penalties for 2004, including $100,000 imposed on each of his minor children ranging from age 8 to age 17.

Taxpayer Creates Welfare Plan for Employee and faces $1,200,000 Penalty: An Iowa businessman establish as welfare benefit plan to provide for one of his employees. The Plan did not benefit the business owner or any member of his family. The IRS determined that the welfare plan was substantially similar to a listed transaction and while saving an aggregate of only about $50,000 of income tax over a 4-year period, the IRS proposed a 6707A penalty of $1,200,000.

Business Owner Paid $13,000 Income Taxes and faces $1,400,000 Penalty: A California woman who owns a printing company established a pension plan for her employees. The IRS examined the pension plan and over a 4 year period she paid aggregate income taxes of $13,000. The IRS has informed the business owner that the pension plan was a listed transaction and the penalty will be $1.400,000.

Owner of coin operated car wash goes bankrupt – Penalty $900,000: In 2002, a seventy-two year old owner of a coin operated car wash finally generated enough revenues to put a retirement plan in place for his seven (7) employees. He decreased his own compensation to free up additional revenues and, with the assistance of his CPA, established a tax-qualified retirement plan. He applied for and received a Letter of Determination from the IRS on the plan. Four years later, the IRS audited the plan and determined, to the surprise of the car wash owner, that the plan was a "listed transaction" beginning in 2004. The seventy- two year-old car wash owner now owes a 6707A listed transaction penalty of $900,000 to the IRS. This sum exceeds the value of virtually every asset he and his sixty-five year old wife own in the aggregate. The car wash company and its owner will seek the Bankruptcy Court's protection.

Physicians who participate in the Global Settlement Initiative receive surprise tax bill -- Penalty $600,000: Two physicians set up a qualified pension plan for themselves and all their employees. Two years later they discovered that the IRS thought their plan was a tax avoidance transaction and that there was a "Global Settlement Initiative" or "GSI" announced by the IRS. [*See* Ann. 2005-80] The physicians disclosed their pension plan and sought participation in the GSI by submitting a Form 13750 to the IRS. After being told by the IRS in its GSI publications that the penalties under the GSI were only 5% of the taxes owed, the physicians signed a Closing Agreement under the GSI. The physicians then received a notice from the IRS telling them they owed $600,000 in penalties under Code section 6707A.

Russian Immigrant becomes citizen and is presented with a $1.2 million dollar tax notice: A young man immigrates to the United States and, after years of work, becomes a successful owner of a construction company and a United States citizen. Upon the advice of his tax attorney, the Russian native establishes an S-Corp. ESOP and a pension plan for himself and his employees. A few years into the ESOP and retirement plan transactions, the ESOP and plan are audited by the IRS. The small business owner discovers the transactions his tax attorney has advised him to undertake for himself and his employees are "listed transactions." The Russian native owes $1.2 million in Code section 6707A penalties.

Father of a disabled child pays dearly for participating in an "insurance fund" which helps pay for the child's care – Penalty $900,000: In 2003, an optician is introduced to a multiple employer welfare arrangement by his CPA. The welfare arrangement acts like an insurance fund and pays, to the delight of the optician, the out-of-pocket medical and educational expenses of his young son, who has a severe impairment. Four years after entering the plan, the IRS sends the optician a letter stating the arrangement is an "abusive tax avoidance transaction" and the optician owes $900,000 in penalties.

Disproportionate Penalty to Tax Underpayment – Penalty $1,200,000: In 2002, these Hawaiian taxpayers (husband and wife), who owned and worked together in a small business, were concerned about how best to save for retirement. Their accountant introduced them to a tax consultant who was a CPA and MBA and professed expertise in the area of retirement plans. The taxpayers were advised to establish a LLC along with Roth IRAs for the purpose of building a retirement fund. In 2008, the IRS audited the LLC and the small business owners. The IRS informed them that it had predetermined that the Roth IRAs transaction was "substantially similar" to the listed transactions under Notice 2004-8. The taxpayers have no right to challenge the IRS determination in court. The IRS completed its audit of the taxpayers and proposed to assess income tax deficiencies of totaling $6,812 respecting the disallowed Roth IRA transactions. In addition, the IRS proposed Section 6707A penalties totaling **$1,200,000**. The proposed penalties under Code Section 6707A are almost 180 times the proposed income tax deficiency. As a result, these small business owners have had to consider bankruptcy and could lose all of their assets and home.

Imperfect Disclosure: Taxpayer filed his Form 8886 with his tax returns, but failed to submit the Form 8886 also to the Office of Tax Shelter Analysis. The IRS assessed the Section 6707A penalty because the taxpayer had not disclosed "perfectly."

Small Business Owner Makes Disclosure on Tax Returns – Penalty $400,000: California business owners of a home remodeling company invested in a retirement plan that the IRS determined to be a listed transaction. The owners filed Form 8886 with their S-Corporation and personal tax returns but were not advised by the CPA to file with the Office of Tax Sheltered Analysis. The owners are facing a $400,000 6707A listed transaction penalty; even thought there has been no determination by the IRS that the retirement plan was abusive.